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# TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



*Employees Are Provided Sufficient  
Information on Their Tax Responsibilities,  
but Additional Actions Are Needed to  
Detect All Noncompliant Employees*

**May 5, 2011**

**Reference Number: 2011-10-047**

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

**Redaction Legend:**

1 = Tax Return/Return Information

2 = Risk Circumvention of Agency Regulation or Statute

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## HIGHLIGHTS

**EMPLOYEES ARE PROVIDED SUFFICIENT INFORMATION ON THEIR TAX RESPONSIBILITIES, BUT ADDITIONAL ACTIONS ARE NEEDED TO DETECT ALL NONCOMPLIANT EMPLOYEES**

## Highlights

**Final Report Issued on May 5, 2011**

Highlights of Reference Number: 2011-10-047 to the Internal Revenue Service Human Capital Officer.

### IMPACT ON TAXPAYERS

The Internal Revenue Service (IRS) redesigned and centralized the Employee Tax Compliance (ETC) Program in Calendar Year 1995 to ensure that employees are held to a high standard of compliance with the tax laws. The IRS has developed processes to educate employees on their tax responsibilities and detect employees who may not have timely filed or timely paid their taxes; however, not all potential employee misconduct concerning noncompliance with tax laws is being assessed, and additional analyses are needed to periodically reevaluate the direction of the Program. To maintain public confidence in the agency trusted with administering the Nation's tax system, the IRS must ensure that potential misconduct concerning noncompliance with tax laws is identified and addressed.

### WHY TIGTA DID THE AUDIT

The overall objective of our audit was to determine whether controls in the ETC Program ensure that IRS employees are fulfilling their tax obligations and employee tax compliance cases are being appropriately identified and resolved.

### WHAT TIGTA FOUND

The IRS Human Capital Office has taken action to ensure education is available to IRS employees on their tax responsibilities and has ensured cases of noncompliance with tax laws are consistently resolved. The IRS has also developed a computer application to detect

employees who may not have timely filed or timely paid their taxes.

Although the IRS developed the computer application, TIGTA determined that the application was not detecting all potential noncompliance. TIGTA independently reviewed IRS computer files over a 2-year period and identified 133 employees who were potentially noncompliant with their taxes and were not detected by the ETC computer application. As a result, no action was taken by the IRS to analyze and address potential employee misconduct for noncompliance with tax laws.

In addition, TIGTA determined the IRS significantly reduced the focus of the ETC Program from its original mission and goals partially based on a study it conducted showing that IRS employees were more compliant compared to the general taxpaying public. While TIGTA understands the IRS's decision to use resources as efficiently as possible, the IRS should document this change and conduct three additional analyses to periodically reevaluate the Program's direction to ensure proper oversight of employees' compliance with their tax obligations.

### WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS Human Capital Officer work with computer programmers to correct the ETC computer application and work additional employee cases identified by TIGTA. The IRS Human Capital Officer should also revise the goals and mission of the ETC Program to align with how it is currently operating and periodically conduct trend analyses of employee tax noncompliance.

In response, the IRS agreed to review its computer application, work additional cases, and revise the goals and mission of the ETC Program. However, the IRS stated it had no plans to develop new noncompliance detection efforts specifically for IRS employees. TIGTA believes it would be prudent for the IRS to conduct trend analyses to assist in evaluating employee noncompliance trends.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

May 5, 2011

**MEMORANDUM FOR** INTERNAL REVENUE SERVICE HUMAN CAPITAL OFFICER

**FROM:**

*Michael R. Phillips*

Michael R. Phillips

Deputy Inspector General for Audit

**SUBJECT:**

Final Audit Report – Employees Are Provided Sufficient Information on Their Tax Responsibilities, but Additional Actions Are Needed to Detect All Noncompliant Employees (Audit # 201010019)

This report presents the results of our review to determine whether controls in the Employee Tax Compliance Program ensure that Internal Revenue Service employees are fulfilling their tax obligations and employee tax compliance cases are being appropriately identified and resolved. This audit was conducted as part of the Treasury Inspector General for Tax Administration Fiscal Year 2011 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

Management's complete response to the draft report is included as Appendix VI.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Nancy A. Nakamura, Assistant Inspector General for Audit (Management Services and Exempt Organizations), at (202) 622-8500.



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## *Abbreviations*

ETC	Employee Tax Compliance
IRS	Internal Revenue Service



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## *Background*

In Calendar Year 2010, members of Congress and the press expressed concern with the number of Federal Government employees who are behind in paying their taxes. According to a December 2009 Internal Revenue Service (IRS) report, more than 97,000 Federal employees were behind in paying their taxes. This prompted Congress to introduce a bill that proposed to remove all Federal employees who were seriously behind on their taxes. As the agency of the Federal Government whose chief mission is to assist taxpayers in meeting their tax responsibilities and enforce tax laws with integrity and fairness, it is particularly important the IRS ensures that its own employees are compliant with the tax laws.

The IRS redesigned and centralized the Employee Tax Compliance (ETC) Program in Calendar Year 1995 to ensure that employees are held to a high standard of compliance with the tax laws and to appropriately address conduct issues that arise when employees do not fulfill their tax obligations. The ETC Program is administered by the IRS Human Capital Office and is the primary means for ensuring IRS employees fulfill their tax obligations and for addressing employees who are noncompliant.

The ETC Program is administered through two separate offices, the ETC Program Office and the ETC Branch.

- The **ETC Program Office** was designed to coordinate and interact with all IRS business units to address employee tax compliance issues. It was also formed to identify trends and issues to proactively address noncompliance; orient, educate, and assist employees in complying with the tax laws; ensure consistency in the treatment of employee tax compliance; and protect employee privacy by restricting access to tax information.
- The **ETC Branch** is a centralized unit of IRS employees who are responsible for researching whether potential noncompliance exists. It is designed to provide consistency, protect employee privacy by restricting access to the minimum number of people necessary to address employee noncompliance with the tax law, and conserve resources by involving the minimum number of people needed to review tax issues.

Most noncompliance cases are identified by a computer application that matches IRS employee payroll records and the tax account records maintained for all taxpayers. The computer application will identify (but is not limited to) instances when an employee potentially did not file a Federal tax return, did not file a tax return timely, did not pay tax owed when due, or



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understated his or her tax liability. Since Program Year<sup>1</sup> 2004, the ETC computer application has annually identified more than 8,000 potential noncompliance cases. Each of these cases required further review and analyses to assess whether the employee was actually noncompliant and whether disciplinary action was warranted. In the end, ETC reports show that about 3 percent of IRS employees are noncompliant each program year. Appendix V provides further statistics regarding the ETC Program, including the type of noncompliance cases that were identified by the IRS computer application for Program Years 2004 through 2008, their outcome based on the research performed by ETC Branch staff, and the percentage of IRS employees identified as being noncompliant with the tax law by program year.<sup>2</sup>

Employee tax issues can also originate through IRS examinations of tax returns, Treasury Inspector General for Tax Administration investigations of IRS employees, special projects, or self-disclosure by an IRS employee. Issues surfaced through these sources may include other types of noncompliance than that identified by the ETC computer application. Information from all of these sources is input to a database maintained by the ETC Branch so that it can review potential tax issues.

When reviewing and analyzing potential noncompliance, technicians in the ETC Branch use a workflow guide to ensure that potential noncompliance cases are worked correctly and consistently. Tax account information is reviewed to assess whether a potential tax noncompliance problem exists and to eliminate instances where employee noncompliance has not occurred, involves a minor/technical error within selected tolerances, or the noncompliance issue has already been addressed by IRS management. For the remaining cases, employees are contacted by letter and provided a chance to explain the potential noncompliance issue and provide perspective. In some instances, information is provided that resolves the issue and the case is closed without any further action. Issues that cannot be resolved or closed are referred to the employee's local management through the IRS Human Capital Office's Workforce Relations Division for further evaluation and administrative action.

Administrative disciplinary actions for tax noncompliance range from oral counseling to suspension or even removal, depending on the severity of the noncompliance and whether there have been repeated or multiple issues. The employee's immediate manager is responsible for interviewing the employee to determine whether disciplinary action is warranted and, if so, the

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<sup>1</sup> The ETC Branch works cases on a program year basis which runs from July 15<sup>th</sup> to July 14<sup>th</sup> of the following year. During this time period, all employees with potential noncompliance issues are identified and placed into the ETC database and then worked by the ETC Branch staff.

<sup>2</sup> The ETC Branch gathers information and makes an assessment on whether noncompliance exists. The preliminary determination on whether noncompliance exists and whether disciplinary action is warranted is made by the IRS employee's manager and second-level manager in consultation with the IRS Labor Relations function. The final determination is made by a senior manager unless it is a Section 1203 violation. Because the discipline for a willful violation of Section 1203 is removal, only the IRS Commissioner can mitigate the penalty to something lesser than removal.



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appropriate discipline to be taken within guidelines set forth in the IRS Penalty Determination Handbook. Managers may also seek advice from an IRS Labor Relations office, which is responsible for ensuring consistency in penalty actions by using similar cases as a guideline in addition to the Penalty Determination Handbook. The proposed disciplinary action must be approved by the employee's second-level manager, as well as a senior manager who is responsible for making the final determination on the appropriate action unless it is a Section 1203 violation.<sup>3</sup> Because the discipline for a willful violation of Section 1203 is removal, only the IRS Commissioner can mitigate the penalty to something lesser than removal.

This review was performed in the IRS Human Capital Office, Workforce Relations Division, Employee Conduct and Compliance function in Washington, D.C., and the ETC Branch in Cincinnati, Ohio, during the period March through November 2010. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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<sup>3</sup> In Section 1203, the IRS Restructuring and Reform Act of 1998 (Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.)) specified that any IRS employee determined to have willfully failed to file any required Federal tax return or willfully understated a tax liability must be terminated from employment with the IRS.





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## *Results of Review*

The IRS has established the necessary processes to educate employees on their tax responsibilities. The IRS Human Capital Office educates employees through a variety of methods, including developing educational tools and creating an internal web site to keep employees informed of their responsibilities. In addition, our analysis concluded that once potential noncompliance is identified, the IRS Human Capital Office has established a process which addresses and resolves employee noncompliance consistently.

Although the IRS developed a computer application that is designed to detect employees who may not have timely filed or paid their taxes or who have understated their tax liability, we determined that the application was not detecting all potential noncompliance. We independently attempted to identify potential employee tax noncompliance and identified some noncompliance issues that were not detected by the ETC computer application. In Tax Years 2006 and 2007, we identified 133 employees who were potentially noncompliant with their taxes according to the IRS Master File<sup>4</sup> and were not detected by the ETC computer application. As a result, no action was taken by the IRS to analyze and address potential employee misconduct for noncompliance with tax laws.

In addition, we determined the IRS significantly reduced the focus of the ETC Program from its original mission and goals partially based on a study it conducted showing that IRS employees were more compliant compared to the general taxpaying public. While we understand the IRS's decision to use resources as efficiently as possible, the IRS should document this change and conduct additional analyses to periodically reevaluate the Program's direction to ensure proper oversight of employees' compliance with their tax obligations.

### ***Controls Were Developed to Ensure Employees Are Aware of Their Tax Obligations and Cases of Noncompliance With Tax Laws Were Consistently Resolved***

Educating employees on their tax responsibilities and administering the appropriate discipline when employees do not meet those obligations are key components of the ETC Program. The IRS implemented these components by ensuring that 1) education is available to IRS employees on their tax responsibilities and 2) processes were implemented to ensure employees who were potentially identified as noncompliant had their issues resolved fairly and consistently.

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<sup>4</sup> The IRS database that maintains transactions or records of individual tax accounts.



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- **The IRS Human Capital Office takes sufficient actions to ensure that employees are aware of their tax responsibilities.** Educational efforts to help employees meet their tax obligations are important because they enable the IRS to proactively stop employee noncompliance before it begins. The Workforce Relations Division within the IRS Human Capital Office has developed sessions for IRS leadership conferences, new employee orientations, and workshops to ensure employees are aware of their responsibility to fulfill their tax obligations. Several educational tools were also developed to facilitate these sessions, including an All Employee Guide and two slide presentation files for employees and managers.

The ETC Program Manager also identifies tax information employees should know about and works with an IRS Internal Communications specialist to put information and resources on an internal ETC web site to help IRS employees stay compliant. The ETC web site has information about how the ETC Program works, as well as what employees should do if they are contacted by the ETC Program. It includes ETC videos about life events and circumstances that could change an employee's tax situation, such as an early withdrawal from a retirement savings account, forgiven credit card debt, and a change in marital status. There is also a yearly email signed by the IRS Human Capital Officer which is sent to employees to remind them to file and pay their taxes accurately and on time. In February 2010, the IRS Human Capital Officer issued a memorandum to all IRS employees advising them where they could get help electronically filing their returns free of charge using commercial tax preparation software or through the IRS Employee *e-File* Program, a free electronic tax filing service available to IRS employees.

- **IRS processes provide reasonable assurance that employees with tax compliance issues are treated fairly and consistently within prescribed guidelines.** We reviewed a statistical sample of 94 closed cases from the ETC database to determine whether outcomes or admonishments had been administered within the guidelines of the ETC Program's Workflow Guide, the ETC Branch Guidelines for Closing/Referring Cases, and the IRS Penalty Determination Handbook. Our review showed that the cases were being consistently processed to ensure that conduct which is inconsistent with the mission of the IRS is not tolerated.

*Our review of closed cases  
found the ETC Program  
processed cases of  
employee noncompliance  
with tax laws consistently.*



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## **Computer Applications Are Not Identifying All Employees Who Are Potentially Noncompliant With Tax Laws**

The ETC computer application developed by the IRS Modernization and Information Technology Services organization is not identifying all potential misconduct by IRS employees who may have not timely filed or paid their taxes or who have been assessed tax penalties for noncompliance with the tax laws. We conducted an independent analysis of the IRS's tax returns database and employee files. Based on our independent analysis, we identified IRS employees who had potentially been noncompliant with the tax law and were not identified by the IRS computer application.

We identified an additional 69 employees in Tax Year 2006 and 64 employees in Tax Year 2007 who were noncompliant with their tax obligations, yet were not identified by the matching application. As a result, these employees were not reviewed by the ETC Program for possible administrative disciplinary actions. While this is a small number of employees compared to the approximately 8,000 cases the ETC Branch works each year, it is important that the IRS strive to identify and appropriately address noncompliance with the tax laws by all of its employees. If all cases are not identified and addressed, the employee noncompliance rate<sup>5</sup> that the IRS uses to evaluate its efforts will be inaccurate.

Figure 1 shows that the IRS computer application was unable to appropriately identify a variety of noncompliance issues.

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<sup>5</sup> See Appendix V for additional information.



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**Figure 1: Noncompliant Employees Not Identified by the ETC Program**

Tax Issue	Tax Year 2006	Tax Year 2007
	Number of Employees	Number of Employees
Filed return late	**1**	**1**
Paid taxes late	**1**	**1**
Accounts receivable balance	**1**	**1**
Additional tax assessment due to income that was not reported	**1**	**1**
Criminal investigation with additional tax assessment	**1**	**1**
<b>Total employees identified with potential noncompliance that were not identified by the IRS's computer application<sup>6</sup></b>	<b>69</b>	<b>64</b>

Source: Treasury Inspector General for Tax Administration analysis of IRS employees' tax account data.

The inability of the computer matching application to identify all potential misconduct by IRS employees for noncompliance with taxes means that some employees may not be appropriately identified for possible administrative action. As the agency of the Federal Government whose chief mission is to administer the Federal tax system, IRS employees are particularly expected to comply with all tax laws. The IRS risks an erosion of public confidence in the American voluntary tax system if it does not appropriately address employees who are not complying with their tax obligations. To maintain this confidence, the IRS must ensure that all potential noncompliance is identified and addressed in a manner that instills public confidence in the Federal tax system.

We discussed the inability of the computer matching application to identify all employee misconduct for potential noncompliance of taxes with representatives from both the ETC Branch and the Modernization and Information Technology Services organization. After researching the cases, both parties agreed that the employees should have been included in the ETC database but the Modernization and Information Technology Services organization could not recreate the results of the computer matching application to determine the systemic issue for the records

<sup>6</sup> Four employees had multiple tax issues for Tax Year 2006, \*\*\*\*\*1\*\*\*\*\*.  
\*\*\*\*\*1\*\*\*\*\*.



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being excluded. As a result, future analysis will need to be conducted to determine why the computer matching application is not identifying all noncompliance by IRS employees and determine what changes are necessary.

## ***Recommendations***

To ensure that all cases involving potentially noncompliant employees are identified and resolved, the IRS Human Capital Officer should:

**Recommendation 1:** Review the ETC Program's computer application with Modernization and Information Technology Services organization programmers and make necessary changes.

**Management's Response:** The IRS agreed with this recommendation. To determine why the cases were not selected by the extract, the Applications Development function within the Modernization and Information Technology Services organization will work with the IRS Human Capital Office's Workforce Relations Division to review:

- Requirements and issue selection criteria in the ETC extract.
- Potential issues that were identified by the Treasury Inspector General for Tax Administration but not identified in the ETC extract.
- The input files for ETC processing as well as the extract application.

At the conclusion of the review, the Applications Development function will write a report indicating the findings and recommended resolution for the IRS Human Capital Office's action. The IRS Human Capital Office will initiate action to make program changes if necessary.

**Recommendation 2:** Work the additional 133 cases identified as part of this audit to determine whether disciplinary action is warranted.

**Management's Response:** The IRS agreed with this recommendation. The ETC Branch began adding the 133 cases to the ETC database. Research of the Integrated Data Retrieval System<sup>7</sup> has been completed on 105 of these cases, which either have been closed pre-contact or are being further worked in accordance with normal ETC processing. The remaining 28 cases are currently being reviewed by the ETC Branch. It is anticipated that all 133 cases will be closed or the ETC process implemented by May 18, 2011. Successfully resolving Recommendation 1 will prevent omissions from occurring in the future.

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<sup>7</sup> IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.



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## ***The Direction of the Employee Tax Compliance Program Has Changed, but It Should Be Periodically Assessed for New Trends***

The IRS Human Capital Office established an ETC Program Office with goals to identify trends and issues that proactively address employee noncompliance, including analyzing employee noncompliance issues and supporting targeted enforcement actions that eventually would reduce employee noncompliance. A committee was established to monitor and evaluate ETC-related issues including data collection, compliance activities, ETC performance measurement, and communications.

However, the IRS made a business decision to change the direction of the Program because it determined that IRS employees in Tax Years 2004 and 2005 were more compliant than the general tax filing population. Also, IRS management concluded that it could use the numerous IRS noncompliance detection systems currently in place to identify employee noncompliance. Management believes that it is appropriate to use the same techniques to identify IRS employee noncompliance that are used to identify noncompliance by the general public and that further development of compliance detection systems designed solely for IRS employee filers is not needed or warranted.<sup>8</sup>

Consequently, the priorities of the ETC Program have evolved into a Program that focuses its resources primarily on educating employees on their tax responsibilities and working cases of potential noncompliance mainly identified by existing compliance detection systems used for all taxpayers. As a result of this change in priorities,

- The documented goals and mission of the ETC Program are not aligned with how the IRS is currently operating.
- Trend analyses are needed to assess the future direction of the Program.

### **The documented mission and goals of the ETC Program are not aligned with its current activities**

Government agencies should have controls in place to ensure that a program meets its objectives. However, the IRS made a significant change in the ETC Program without revising the mission and goals of the Program. Without clearly documented mission and goals, it is not possible to measure objectively whether the Program is operating effectively or efficiently.

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<sup>8</sup> For example, some noncompliance issues, such as unreported income, are identified by processes which match transactions reported by third parties (e.g., employers) with transactions reported on the tax return (e.g., wages). Other processes, such as the Discriminate Function, score tax returns for examination potential. Examinations and criminal investigations of tax returns are also conducted, which may require the inspection of taxpayer records by an IRS employee. These techniques are designed to uncover inappropriate deductions, fraudulent filings, etc.





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The IRS Human Capital Office created an ETC Program Manager position with the responsibility to incorporate employee education, noncompliance detection, and noncompliance administrative actions into the ETC Program Office. The Program Manager was also tasked with coordinating the activities of an ETC data analysis group, which was supposed to be established to analyze employee compliance issues for targeting enforcement actions<sup>9</sup> and building strategies for reducing employee noncompliance. The IRS also established an ETC Committee to monitor and evaluate ETC-related issues.

***The IRS made a significant change to the focus of the ETC Program. However, it did not document the change in mission or goals, which is important for objectively measuring the Program.***

Since the establishment of the ETC Program Office, the ETC Program Manager's job has evolved into activities that are focused almost exclusively on making employees aware of their tax responsibilities and educating them on the processes used by the ETC Program for addressing tax compliance issues. While some data analysis was provided by another business unit in the past, a dedicated ETC data analysis group was never established, and no alternative process was established to regularly analyze noncompliance issues or provide data to support targeted enforcement actions. In addition, the ETC Committee no longer meets. While we understand the IRS's change in direction, the goals and mission of the ETC Program should be updated.

**Trend analyses could help assess the future direction of the ETC Program**

The lack of a data analysis group and an ETC Committee reduced the IRS's capability to analyze employee data and address employee noncompliance issues proactively. One function of the ETC Committee was to serve as a clearinghouse for proposed noncompliance detection projects by reviewing and evaluating them before forwarding them to the IRS 1203 Review Board for approval.<sup>10</sup> When the ETC Committee was active, it contained different IRS managers who were in favor of proactively identifying employee noncompliance. In fact, the ETC Committee submitted a project to the 1203 Review Board, but the Board rejected it because in its opinion the expected results did not justify the expenditure of examination resources. Since the 1203 Review Board declined this project and the ETC Committee stopped meeting in Calendar Year 2007, no other proactive noncompliance detection projects have been submitted to the Board.

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<sup>9</sup> Examples of targeted enforcement actions include enhanced noncompliance detection procedures, surfacing and exploring noncompliance issues and trends, and early intervention to correct problems such as expeditiously identifying and auditing employee returns suspected of participating in abusive tax avoidance transactions.

<sup>10</sup> The Section 1203 Review Board is responsible for evaluating the circumstances surrounding a Section 1203 violation and either making a recommendation to the IRS Commissioner for reducing the penalty for employee misconduct or concluding that a reduction is not warranted.



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While we understand the IRS's decision to use resources as efficiently as possible, by not creating new processes to proactively identify IRS employee noncompliance with tax laws and not designing compliance detection systems solely for IRS employees, the IRS increases the risk that employees with knowledge of IRS processes could be noncompliant with tax laws and not be detected. \*\*\*\*\*2\*\*\*\*\*

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\*\*\*\*\*2\*\*\*\*\*. These noncompliance issues are generally

identified through the IRS's existing enforcement programs; however, the enforcement programs may not identify or work all instances of potential noncompliance. As a result, employee noncompliance in these areas may not always be identified or addressed.

To monitor this risk, the IRS should conduct three additional analyses that could assist the organization in periodically reevaluating its direction for the ETC Program.

*While we understand the IRS's decision to change the focus of the Program, we believe the IRS should conduct trend analyses of employee noncompliance and periodically reevaluate its direction.*

1. **Periodic analyses of IRS employee noncompliance trends over multiple tax years** – One of the reasons that IRS management provided for changing the direction of the ETC Program was the results of an in-depth study it conducted of IRS employee compliance with tax laws using Tax Years 2004 and 2005 compliance rates for employees. The study made several conclusions, including that IRS employees were more compliant than the general public. The study was scheduled to be updated for more recent tax years in Fiscal Year 2010 but was not updated. Not only do we believe this study should be updated periodically, we believe the existing method of computing employee noncompliance should be changed to align with the way noncompliance from the general public is computed. The employee noncompliance rate that is computed by the ETC Program excludes some instances where an employee was determined to be noncompliant but further disciplinary action was not warranted. This differs from the way that the IRS calculates noncompliance for the general public, which measures all taxpayers that do not timely file returns, make accurate reports on those returns, and pay the required tax voluntarily and timely. Without conducting this study periodically and making consistent comparisons, the IRS may not be aware of changing employee patterns. If compliance rates were to shift toward more noncompliance, the IRS would not have the detailed information to determine whether additional educational efforts or proactive noncompliance detection projects are needed.
2. **Trend analyses of referrals received by the ETC Branch that would not have been identified by the ETC computer application** – As noted previously, the ETC Branch receives some of its casework from examinations of IRS tax returns and investigations conducted on IRS employees, as well as employees who self report that they have been





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noncompliant with tax laws. Examinations are based on a review of books and records and can uncover more sophisticated noncompliance than that detected by some of the automated compliance systems the IRS uses. In addition, investigations may also reveal noncompliance that is not detected by the IRS's computer systems. For example, we recently determined that 128 IRS employees claimed the First-Time Homebuyer Credit even though prior tax returns had indicated they may not be eligible.<sup>11</sup> We have also issued additional audit reports regarding other deductions IRS employees were taking inappropriately.<sup>12</sup> While these cases were referred to the ETC Program, none of these examples would have been automatically detected by the IRS's computer systems at the time. Therefore, these cases would not have been worked by the ETC Branch without the referral process. Analyzing referrals and self-reported noncompliance by employees for trends could assist the IRS in determining whether additional educational efforts or proactive noncompliance detection projects are needed.

3. **More detailed trend analyses of noncompliance identified by the ETC computer application** – Through its Workforce Relations Division, the IRS evaluates the overall tax compliance of its employees by monitoring the percentage of employees who are noncompliant, as well as the number of tax issues associated with these employees. However, the evaluation does not break down the statistics any further to show the number of noncompliant employees by location, job series, or other factors. By breaking down noncompliance data further, the IRS could periodically determine whether additional targeted educational efforts or targeted proactive noncompliance detection projects are needed.

## ***Recommendations***

To ensure that changes in the direction of the ETC Program are clearly communicated and documented, the IRS Human Capital Officer should:

**Recommendation 3:** Revise the goals and mission of the ETC Program to align with how the Program is currently operating.

**Management's Response:** The IRS agreed with this recommendation. The ETC Program Manager will develop new language that aligns the mission and goals of the ETC Program with current operating procedures and communications.

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<sup>11</sup> *The Internal Revenue Service Faces Significant Challenges in Verifying Eligibility for the First-Time Homebuyer Credit* (Reference Number 2009-41-144, dated September 29, 2009).

<sup>12</sup> For example, *Improvements Are Needed in the Administration of Education Credits and Reporting Requirements for Educational Institutions* (Reference Number 2009-30-141, dated September 30, 2009).



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To determine whether future changes are needed in the direction of the ETC Program, the IRS Human Capital Officer should:

**Recommendation 4:** Conduct trend analyses of employee noncompliance with tax laws to include, but not be limited to:

- Periodic analyses of employee noncompliance trends over multiple tax years.
- Analyses of referrals received by the ETC Branch that would not have been identified by the ETC computer application.
- More detailed analyses of noncompliance identified by the ETC computer application.

**Management's Response:** The IRS disagreed with this recommendation. The IRS feels that its current processes and procedures for noncompliance detection are sufficient in number and appropriate in scope. Accordingly, the IRS has no plans at this time to develop new noncompliance detection efforts specifically for IRS employees.

**Office of Audit Comment:** While we understand the IRS's decision to use resources as efficiently as possible by not creating new processes to proactively identify IRS employee noncompliance with tax laws and not designing compliance detection systems solely for IRS employees, the IRS is at risk that employees with knowledge of IRS processes could be noncompliant with tax laws and not be detected. In addition, without conducting analyses periodically, the IRS may not be aware of changing employee patterns.

The intent of our recommendation was not to introduce resource-intensive or overly burdensome noncompliance detection analyses to the ETC Program. Instead, we believe it would be prudent for the IRS to periodically (e.g., annually or in some cases over multiple years) conduct trend analyses to determine whether employee noncompliance levels have increased and whether additional educational efforts or proactive noncompliance detection projects are needed.



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## **Appendix I**

### *Detailed Objective, Scope, and Methodology*

Our overall objective was to determine whether controls in the ETC Program ensure that IRS employees are fulfilling their tax obligations and employee tax compliance cases are being appropriately identified and resolved. To accomplish this objective, we:

- I. Determined the current business results, organizational responsibility, and structure for the ETC Program.
  - A. Determined the organizational responsibility and structure of the ETC Program.
  - B. Determined how the ETC Program was identifying and monitoring noncompliance trends by evaluating whether data and research systems were being used to monitor overall compliance within the IRS filing community and whether research was being used to enhance noncompliance detection procedures and surface noncompliance issues and trends.
  - C. Determined the results of the ETC Program by reviewing case closure data for Program Years<sup>1</sup> 2004 through 2008.
- II. Determined how IRS Human Capital Office management measures the goals and mission of the ETC Program.
  - A. Identified the goals and objectives of the ETC Program by interviewing the IRS Human Capital Officer, ETC Branch Chief, ETC Program Manager, and a Labor Relations/Employee Relations Field Operations Branch Senior staff member and by reviewing applicable documentation, such as Internal Revenue Manual sections, Business Plans, and Business Performance Reviews.
  - B. Interviewed IRS Human Capital Office management to determine the performance measures they use to evaluate ETC Program results.

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<sup>1</sup> The ETC Branch works cases on a program-year basis which runs from July 15<sup>th</sup> to July 14<sup>th</sup> of the following year. During this time period, all employees with potential noncompliance issues are identified and placed into the ETC database and then worked by the ETC Branch staff.



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- III. Determined whether potential tax noncompliance by IRS employees was being identified and consistently resolved, if substantiated.
- A. Determined whether the ETC database was complete by matching the Treasury Integrated Management Information System<sup>2</sup> file to the Individual Master File<sup>3</sup> for Tax Years 2006 and 2007 to produce data on IRS employees who were potentially noncompliant and compared the results to the ETC database to validate that potentially noncompliant employees were appropriately identified. The information was gathered using the Treasury Inspector General for Tax Administration's Data Center Warehouse. The reliability and validity of the Data Center Warehouse files was assessed by testing a sample of taxpayer and employee accounts and comparing the sample to Master File transcript information to confirm the validity of the information.
  - B. Determined whether cases identified in the ETC database were being consistently resolved by generating a statistical sample of 94 closed ETC cases from the ETC Branch Program Year 2008 database and reviewing the case files to determine whether the outcomes or admonishments were administered within the guidelines of the ETC Workflow Guide and IRS Penalty Determination Handbook. The statistical sample was based on a population of 6,459 ETC cases with a 2 percent precision, a 1 percent expected error rate, and a 95 percent confidence level. The reliability of the ETC database information was assessed by tracing a sample of ETC closed cases to the Master File.

**Internal controls methodology**

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: IRS Human Capital Office procedures, ETC Workflow Guide, ETC Branch Guidelines for Closing/Referring Cases, the IRS Penalty Determination Handbook, and the IRS's computer application designed to detect employee noncompliance with tax laws. We evaluated these controls by interviewing management, reviewing documentation, reviewing a statistical sample of cases to ensure they were consistently resolved, and comparing the results of our own analysis of employee noncompliance to the ETC database.

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<sup>2</sup> The Treasury Integrated Management Information System contains current and separated IRS employees. Data in this system include Personally Identifiable Information (name, address, date of birth, Social Security Number) and IRS identification information (entrance-on-duty date, title, series, division, bargaining unit status, separation date, etc.).

<sup>3</sup> The IRS database that maintains transactions or records of individual tax accounts.



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## **Appendix II**

### *Major Contributors to This Report*

Nancy A. Nakamura, Assistant Inspector General for Audit (Management Services and Exempt Organizations)

Troy D. Paterson, Director

James V. Westcott, Audit Manager

Marjorie A. Stephenson, Lead Auditor

Andrew J. Burns, Senior Auditor

Steve T. Myers, Senior Auditor

Michael A. McGovern, Auditor

Allison P. Meyer, Auditor

Carol A. Rowland, Auditor



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## **Appendix III**

### *Report Distribution List*

Commissioner C

Office of the Commissioner – Attn: Chief of Staff C

Deputy Commissioner for Operations Support OS

Deputy Commissioner for Services and Enforcement SE

Chief Technology Officer OS:CTO

Commissioner, Small Business/Self-Employed Division SE:S

Director, Workforce Relations OS:HC:R

Chief Counsel CC

National Taxpayer Advocate TA

Director, Office of Legislative Affairs CL:LA

Director, Office of Program Evaluation and Risk Analysis RAS:O

Office of Internal Control OS:CFO:CPIC:IC

Audit Liaisons:

Commissioner, Small Business/Self-Employed Division SE:S

Internal Revenue Service Human Capital Officer OS:HC



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## **Appendix IV**

### *Outcome Measure*

This appendix presents detailed information on the measurable impact that our recommended corrective action will have on tax administration. This benefit will be incorporated into our Semiannual Report to Congress.

#### **Type and Value of Outcome Measure:**

- Reliability of Information – Actual; 133 instances of employee noncompliance not identified by the ETC computer application (see page 6).

#### **Methodology Used to Measure the Reported Benefit:**

Using Treasury Inspector General for Tax Administration Data Center Warehouse files, we created a file containing tax records of IRS employees for Tax Years 2006 and 2007. By matching IRS employee payroll files to taxpayer account files, we were able to analyze various indicators of noncompliance with taxes. Indicators included transaction codes, action codes, and filing dates that exceeded return due dates. Employees that had indications of noncompliance with taxes were then extracted from the data and added to an “employee noncompliance” file, one for each tax year. We then matched this file to the ETC database to determine which employees were not identified on the ETC database.

For Tax Years 2006 and 2007 respectively, 69 employees and 64 employees with tax compliance issues were not identified by the computer application. These 133 employees meet the requirements for being identified by the computer application and were not included in reports showing the amount of employee noncompliance.



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**Appendix V**

*Employee Tax Compliance Program Statistics*

Employee tax issues are primarily identified through a systemic approach that matches employee payroll files with the tax account files of all taxpayers. The application is designed to identify 1) IRS employees who did not file a Federal tax return, did not file timely, did not timely pay, or had an existing unpaid balance on their accounts and 2) employees who were assessed penalties for failure to pay, penalties for not making sufficient estimated tax payments, or other civil penalties.

Since Program Year<sup>1</sup> 2004, the ETC computer application has identified more than 43,000 potential noncompliance issues. Figure 1 shows the type of noncompliance that was identified for Program Years 2004 through 2008.<sup>2</sup>

**Figure 1: Number of Potential Noncompliance Issues  
(Program Years 2004–2008)**

Type of Noncompliance	Number of Potentially Noncompliant Issues					Total
	Program Year 2004	Program Year 2005	Program Year 2006	Program Year 2007	Program Year 2008	
Did not file tax return	902	1,553	2,394	1,860	1,023	7,732
Did not pay taxes	1,668	2,285	2,030	1,952	2,579	10,514
Filed return late or paid tax due late	5,641	4,162	6,025	4,019	3,734	23,581
Additional tax assessment	152	252	300	395	460	1,559
Other	11	48	73	132	291	555
<b>Totals</b>	<b>8,374</b>	<b>8,300</b>	<b>10,822</b>	<b>8,358</b>	<b>8,087</b>	<b>43,941</b>

Source: IRS ETC Branch.

<sup>1</sup> The ETC Branch works cases on a program year basis which runs from July 15<sup>th</sup> to July 14<sup>th</sup> of the following year. During this time, all employees with potential noncompliance issues are identified, placed into the ETC database, and worked by the ETC staff. Employees can have multiple potential noncompliance issues for multiple tax periods.

<sup>2</sup> The ETC Branch gathers information and makes an assessment on whether noncompliance exists. The preliminary determination on whether noncompliance exists and whether disciplinary action is warranted is made by the IRS employee's manager and second-level manager in consultation with the IRS Labor Relations function. The final determination is made by a senior manager unless it is a Section 1203 violation. Because the discipline for a willful violation of Section 1203 is removal, only the IRS Commissioner can mitigate the penalty to something lesser than removal.





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Figure 2 describes the outcomes of the cases for Program Years 2004 through 2008 based on the research performed by ETC Branch staff.

**Figure 2: Outcome of Employee Issues  
(Program Years 2004–2008)**

Outcome	Program Year					Total
	2004	2005	2006	2007	2008 <sup>3</sup>	
Noncompliant <sup>4</sup>	2,850	2,914	3,172	2,995	3,242	15,173
No Action Warranted <sup>5</sup>	5,524	5,386	7,650	5,363	4,839	28,762
<b>Total</b>	<b>8,374</b>	<b>8,300</b>	<b>10,822</b>	<b>8,358</b>	<b>8,081</b>	<b>43,935</b>

Source: IRS ETC Branch.

The percentage of employees identified as noncompliant by the ETC Branch is a measure used by the IRS Human Capital Office to monitor the ETC Program. The IRS uses this information to determine differences in compliance rates between IRS employees and the general public. The IRS evaluates the overall tax compliance of its employees by monitoring the percentage of employees identified as being noncompliant, as well as the number of tax issues associated with the employees' noncompliance. Figure 3 shows that the percentage of IRS employees identified as noncompliant has remained relatively steady for the last several program years.

<sup>3</sup> As of November 23, 2010, six cases remain open for Program Year 2008.

<sup>4</sup> The ETC Branch gathers information and makes an assessment on whether noncompliance exists. The preliminary determination on whether noncompliance exists and whether disciplinary action is warranted is made by the IRS employee's manager and second-level manager in consultation with the IRS Labor Relations function. The final determination is made by a senior manager unless it is a Section 1203 violation. Because the discipline for a willful violation of Section 1203 is removal, only the IRS Commissioner can mitigate the penalty to something lesser than removal.

<sup>5</sup> "No Action Warranted" refers to cases that were reviewed by ETC Branch staff and closed after research. This includes cases where the employee no longer works for the IRS, cases where employees sent a response to the ETC Branch explaining circumstances that warrant no further action by IRS management, and cases where the IRS determined the employee was compliant with all tax obligations. The measure used by the ETC Branch to monitor employee noncompliance includes instances where employees were noncompliant, but circumstances warranted no further disciplinary action on the part of IRS management.



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**Figure 3: Percentage of IRS Employees Identified as Noncompliant With the Tax Law (Program Years 2004–2008)**

Program Year	IRS Population	Percentage of Employees With Noncompliance <sup>6</sup>
2004	103,961	2.74%
2005	108,001	2.70%
2006	105,443	3.00%
2007	107,160	2.80%
2008	109,469	2.79%

*Source: IRS Workforce Relations Operational Review Report as of October 1, 2010.*

<sup>6</sup> The actual percentage of noncompliant employees will be less because the percentage calculation is based on issues, not employees.



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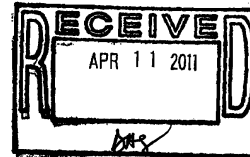
**Appendix VI**

*Management's Response to the Draft Report*



HUMAN CAPITAL OFFICE

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
• WASHINGTON, D.C. 20224



April 11, 2011

MEMORANDUM FOR MICHAEL R. PHILLIPS  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM:

James P. Falcone *James P. Falcone*  
IRS Human Capital Officer

SUBJECT:

Draft Audit Report – Employees are Provided Sufficient  
Information on their Tax Responsibilities, but Additional  
Actions Are Needed to Detect All Noncompliant  
Employees (Audit # 201010019) – e-trak #2011-19807

Thank you for allowing us to review and comment on the subject draft report. We are pleased with the education and outreach efforts our Employee Tax Compliance (ETC) Program has developed since its creation in 2005. These include development and delivery of train-the-trainer sessions for IRS leadership, especially for campus components. Other efforts include new employee orientations, manager presentations, employee handouts, and two key publications about Section 1203 of the Internal Revenue Code and related tax compliance. The ETC program manager develops information every year that alerts employees to important tax changes and key conduct trends. We have nurtured excellent relationships with key stakeholders in ETC, including Small Business/Self Employed, Wage & Investment, and Internal Communications.

We are also pleased with the most recent compliance results from the Federal Employee and Retiree Delinquency Initiative (FERDI) office. FERDI reported in its September 2010 analysis that employees of the Department of the Treasury (Treasury) were more than 99% compliant with their federal income tax obligations. IRS employees, who make up 87% of all Treasury employees, were 99.25% compliant. We are committed to quickly analyzing and fairly adjudicating all potential employee tax noncompliance issues and believe we have the appropriate systems in place to do so.

We agree with most of your recommendations. We will provide support to Modernization and Information Technology Services (MITS) in their attempts to determine the cause of the omitted employee tax cases and to prevent future omissions. We are currently reviewing the 133 tax issues not selected for the ETC



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extract and anticipate completion of this review shortly. We agree with revising the goals and mission of the ETC Program office so that it is in line with how the program is currently operating. Finally, we disagree with Recommendation 4 and have provided our response in the attachment to this memorandum.

Attached are our specific comments on your recommendations. If you have any questions, please contact me, or a member of your staff may contact Christine Adams at 202-622-9363.

Attachment



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Attachment

**Recommendation 1:** Review the ETC Program's computer application with Modernization and Information Technology Services organization programmers and make necessary changes.

**Corrective Action:** We agree with this recommendation. To determine why the cases were not selected by the extract, Applications Development function within Modernization and Information Technology Services will work with the Human Capital Office's Workforce Relations Division (WRD) to review:

- Requirements and issue selection criteria in the ETC extract;
- Potential issues that were identified by the Treasury Inspector General for Tax Administration but not identified in the ETC extract; and
- The input files for ETC processing as well as the extract application.

At the conclusion of the review, Applications Development will write a report indicating the findings and recommended resolution for HCO's action. HCO will initiate action to make program changes if necessary.

**Implementation Date:** January 15, 2012

**Responsible Official(s):** Director, Workforce Relations Division, Human Capital Office

**Corrective Monitoring Plan:** This corrective action will be monitored on JAMES and as part of the WRD Operations Review until completed.

**Recommendation 2:** Work the additional 133 cases identified as part of this audit to determine whether disciplinary action is warranted.

**Corrective Action:** We agree with this recommendation. The ETC Branch began adding the 133 cases to the ETC database. Research of Integrated Data Retrieval System has been completed on 105 of these cases, which have either been closed pre-contact or are being further worked in accordance with normal ETC processing. The remaining 28 cases are currently being reviewed by the ETC Branch. It is anticipated that all 133 cases will be closed or the ETC process implemented by May 18, 2011. Successfully resolving recommendation #1 will prevent omissions from occurring in the future.

**Implementation Date:** May 15, 2011

**Responsible Official:** Director, Workforce Relations Division (WRD), Human Capital Office



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**Corrective Action Monitoring Plan:** This corrective action will be monitored on JAMES and as part of the WRD Operations Review until completed.

**Recommendation 3:** Revise the goals and mission of the ETC Program to align with how the Program is currently operating.

**Corrective Action:** We agree with this recommendation. The ETC Program Manager will develop new language that aligns the mission and goals of the ETC Program with current operating procedures and communications.

**Implementation Date:** May 15, 2011

**Responsible Official:** Director, Workforce Relations Division (WRD), Human Capital Office

**Corrective Action Monitoring Plan:** This corrective action will be monitored on JAMES and as part of the WRD Operations Review until completed.

**Recommendation 4:** Conduct trend analyses of employee noncompliance with tax laws to include, but not be limited to:

- Periodic analyses of employee noncompliance trends over multiple tax years;
- Analyses of referrals received by the ETC Branch that would not have been identified by the ETC computer application; and
- More detailed analyses of noncompliance identified by the ETC computer application.

**Corrective Actions:** We disagree with this recommendation. We feel that our current processes and procedures for noncompliance detection are sufficient in number and appropriate in scope. Accordingly, we have no plans at this time to develop new noncompliance detection efforts specifically for IRS employees.

**Implementation Date:** Not applicable

**Responsible Official:** Not applicable

**Corrective Action Monitoring Plan:** Not applicable